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# European Governance Matters for Portugal

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## Introduction[1]

Two recent events, which impact on European governance, are most relevant for Portugal: the mid-term review of the commitment adopted by the Lisbon European Council in 2000 and the pause in the process of ratification of the Constitutional treaty after the negative outcome of the French and Dutch referendums. This presentation, organized into three sections, addresses the two events and their implications for Portugal. As the latter topic reflects the multiple allegiances of the Portuguese, it represents an idea of Europe that may be of relevance to other EU members and to other Portuguese speaking countries. The three sections cover the following points:

1. Globalization interacts with governance at national, regional and global level and the interaction goes beyond OECD countries (table 1). In the comparison of structural indicators shown in tables 2, 3 and 4, the recent EU enlargement to 25 members does not make a substantial difference in the comparison with the US, which underlies the so-called Lisbon strategy for growth and jobs.

2. The Constitutional treaty does not meet simple tests for separation of powers but it contains a useful flexibility clause, broader than in the Nice treaty, which can be seen as a good example of the Euro-centric perspective on global governance (graph 1).

3. In spite of featuring the most stable borders, Portugal sees itself as peripheral to Europe, weakening the ability to combine allegiances to the European and Lusophone communities. Moreover the interaction between political and financial freedom has maintained a rigid and inward looking fiscal constitution, with negative repercussions on the quality of governance in

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Portugal, especially when primary government expenditure continues to grow as % of GDP (graph 2).

Since the government of the Socialist party earned an overall majority in the February 20, 2005 general elections, Portugal should be able to embark on a sustained program of structural reforms along the lines of the Lisbon strategy. Political uncertainty in Europe should not prevent it. The more regional governance matters worldwide, the more this conclusion is applicable to countries outside the EU.

## 1. Globalization and the Lisbon strategy

As outlined in OECD (2003), globalization interacts with governance at national, regional and global level (G&G). The G&G interaction goes beyond OECD countries and includes BRICs, together with developing countries, including aid dependent ones (table 1). A positive G&G interaction implies convergence in standards of living. This in turn requires appropriate policies, which can be brought about by peer pressure, perhaps intermediated by international organizations. Regional integration reinforces peer alignment, contributing to effective surveillance. Even in the EU, where policy review processes are very intensive, pay-offs and punishments are not always sufficient to bring about best practices. Regional governance in Europe includes various layers (eurozone, EU, candidates & neighbours in South and East, ACP partners). European governance can be seen as an extreme example of peer pressure, since some of the policies are common and some of the rules binding.

Countries whose policies related to property rights and to integration of the economy into international trade do not qualify as appropriate do not converge. The capacity to cope with a volatile international environment is the main difference between emerging markets and mature democracies.

The problem of peer pressure is worse at the global level, where the dominance of the OECD in world output is threatened. Table 1 summarizes the evidence on the so-called BRICs.

While there may be some evidence of effective peer pressure with respect to macroeconomic policy, it is far less clear that structural policies are sufficiently comparable to allow for effective benchmarking. The issues raised by the Lisbon strategy can be addressed in this framework. After a notorious slippage in implementation, the new Commission formally abandoned the commitment of the European Council of Spring 2000, making Europe "the most dynamic and competitive knowledge-based economy in the world" by 2010. At the request of European Council of Spring 2004, the mid-term review at European Council of Spring 2005 was preceded by Kok (2004), which addressed question: How to face the challenge of combining growth and employment in an enlarged union facing a competitive North America and Asia?

As mentioned in the Commission website "The reform package consists of 28 main objectives and 120 sub-objectives, with 117 different indicators. The reporting system for 25 Member States adds up to no fewer than 300 annual reports. Nobody reads of all of them. To remedy this lack of commitment of Member States, the Commission proposed to establish a new kind of partnership with Member States. It also decided to focus efforts on two main areas: productivity and employment. To make things simpler and more coherent, there should be just one national growth programme and one EU growth plan. The European Union cannot boost productivity and employment if Member States do not do their part". Accoridng to Kok (2004), the Commission should present to the Council and the wider public annual updates on these key 14 Lisbon indicators in the format of league tables with rankings (1 to 25), praising good performance and castigating bad performance. Despite announced overhaul, no league table has yet been agreed at the European Council level. The suggestion is to name, shame and fame, a proposal that becomes in European jargon: CI(SR)2 <= CM+OMC or Comprehensive, Interdependent and Self Reinforcing Series of Reforms brought about by Community Method and Open Method of Coordination. Other suggestions include peer pressure and benchmarking facilitate exchange of best practice, making better use of the 14 indicators, better communication of the results in order to ratchet up the political consequences of non-delivery.

According to the same report, there are five areas of policy in which urgent measures are needed. First, with respect to the knowledge society, increase Europe's attractiveness for researchers and scientists; make R & D a top priority and promote the use of information and communication technologies (ICTs). Second, with respect to the internal market, complete the internal market for the free movement of goods and capital and create a single market for services. Third with respect to the business climate, reduce the total administrative burden, improve the quality of legislation, facilitate the rapid start-up of new enterprises and create an environment more supportive to businesses. Fourth, with respect to the labour market, deliver on the recommendations of the European Employment Taskforce, develop strategies for lifelong leaning and active ageing and underpin partnerships for growth and employment. Fifth, with respect to environmental sustainability, spread eco-innovations and build leadership in eco-industry; pursue policies which lead to long-term and sustained improvements in productivity through eco-efficiency.

Structural indicators benchmarks shown in tables 2, 3 and 4 were rebased after the report but there are no major differences between EU15 and 25 averages in Table 2, where the distance to the US and the targets for 2005 and 20101 are apparent. Tables 3 and 4 add the data for Portugal and Sweden, close to the extremes of the ranking of the 15 old member states.

## 2. Constitution and Flexibility

The "Convention on the future of Europe" approved a complex Constitutional treaty, which does not meet simple tests for separation of powers, as illustrated e.g. in *The Federalist papers.* Its ratification process was stopped after the French and Dutch no, prompting a pause in the process. Text is complex, does not meet simple tests for separation of powers and is not a Constitution but a treaty. It maintains a divided executive (especially in foreign policy), a reinforced parliament and an unaccountable court of justice. The ambiguity in the status of a rule about rules extends to its amendment (Lemasson 2004). While the process has been stopped, the text contained a useful flexibility clause, which can be seen as a good example of the “Euro-centric perspective” (ECG) on global governance.

Proximity (also called “subsidiarity”) suggests governance responses at the appropriate level, through the combined action of elected officials and civil society (including business). The common good may be provided by regional institutions, as long as the various levels of government are appropriately combined. “Flexible integration” (CEPR 1996) generalises the principle of proximity from geography to issue areas.

The Euro delivered convergence and cohesion because the "new politics of credibility" overcame financial hierarchy among sovereign risks. Trade unions recognised the perverse interaction between price and wage increases (which hurts the poor and unemployed disproportionately) and public opinion accepted the medium term stance of policy. Yet it took longer to convince voters than markets, and some countries used the Euro to procrastinate on their unpopular reforms, threatening the benefits of the stability culture (“€ hold up” as discussed in Buiter and Siebert 1997).

Drawing on CEPR (1996), graph 1 shows the components of the Eurosystem (Euro Group, Stability Pact, European Central Bank) where the question of credibility is different to the extent that a single monetary policy reinforces the multilateral surveillance framework. The graph is drawn under the assumption that, for any given number of member states, there is a trade-off between the freedom to enter into contractual agreements which include some members and exclude others and the ultimate requirement of "one man, one vote" which would be associated with a new state emerging from the integration of all members. Each pillar of the European Union (Community, Justice and Home Affairs, Common Foreign and Security Policy) is shown in graph 1. .

Since its meeting in Brussels in late 1993, the European Council has been issuing Broad Economic Policy Guidelines (BEPG) against which policy and performance in the member states are to be gauged. This has become a regular test of the multilateral surveillance framework for all EU member states. The progress of policy reform stands on how effective this surveillance framework might be among union officials whose interaction with national officials should be accountable in their respective parliaments and in the European parliament. This has been a dynamic process moving EU member countries' national policies towards integration leading to binding recommendations and sanctions. The EU uses different surveillance processes for different policy areas (Stability and Growth Pact, Luxemburg process for social issues, Lisbon, etc) and coherence among them is not ensured.

Evidence from the markets assembled by Persaud and Metcalfe (2002) suggested in 2001 that SGP has helped credibility by alleviating concerns about "the free rider problem that potentially arises with the adoption of a common currency across a group of states with national budgets". The November 2003 suspension of SGP hurt credibility; but reform might bring it back. Conversely, the failure of the fiscal rules included in the SGP impacted on the characteristics of the public good provided by the Eurosystem, as vigorously argued by the European Commission and Central Bank. In addition, in the Treaty, the one area where subsidiarity does not apply is the compilation of data – it had been recognised that unless there was agreement on the facts under consideration it would not be possible to move discussion on to the next stage.

The Nice treaty and Constitution provide the possibility of making use of "enhanced co-operation" in the Community and JHA pillars (e.g. euro, Schengen). Due to the "snowballing" effect of flexible integration (which may lead initially reluctant states to join in), this is a major improvement in the EU institutional framework but *flexible integration* does not apply to common resources (tax or otherwise) where there are free ride problems.

If countries use monetary union to procrastinate on their unpopular reforms, the benefits of the stability culture may vanish both at the core and at the peripheries. This is the danger of a "€ hold up". It basically reflects the EU institutional structure and the limited role that reinforced co-operation has played so far. Because it could not carry out needed reforms, especially in the public sector, primary government expenditure continued to grow as % of GDP (graph 2).

## 3. Portugal between EU and CPLP

In spite of “territorial imperative” stemming from most stable European border, Portugal sees itself as peripheral to Europe, perhaps as a bridge to the South. This can be a weakness or a strength depending on the G&G interaction, in this case between the allegiances to the European and Lusophone communities. Multiple allegiances may be fate (as in my 1995), but the interaction between political and financial freedom has maintained a rigid and inward looking fiscal constitution, with negative repercussions in the quality of governance in Portugal.

*History*

Portugal sees itself as peripheral to Europe. This peculiar reaction to its role in the Discoveries developed after the inconvertibility of the *real* (1797), the Napoleonic wars and Brazil’s independence. The tension between political and financial freedom emerged during the 19th century and was exacerbated by the Republican revolution in 1910 and its unstable aftermath (my 2001). The *new state* (1926-74) eliminated the country's reputation as a serial defaulter but repressed civil rights, reinforcing a proximity to Latin America found by Russett (1967). The converse happened between precipitous nationalizations and decolonization in 1975 and European integration in 1986. Financial reputation was restored under a stable government in 1992, but the tension is still part of the civic culture (Magone 1997). A recent example is the debate on the 2005 government budget, on which more below

On top of this tension, the interaction between the allegiances to the European and Lusophone communities (CPLP, set up in 1996 with Brazil and 5 African states, now also Timor), can be conflicting. While the establishment of CPLP Business Council in 2004 may help, it is still too early to tell whether the internationalization of Portuguese firms will encompass Brazil, let alone aid receiving countries.

Portugal's successful experience with international economic interdependence, beginning with the Organization for European Economic Cooperation (OEEC) and the European Payments Union (EPU) has been largely ignored. On the contrary, acknowledgment of the success of the accession to the European Community in 1986 and to the eurozone in 1998 is widespread. This is the view of Portugal as a "good student". But the student has a bad fiscal constitution (my 2005).

Moreover, Portugal's European integration did not alleviate this constraint by improving the fiscal constitution, on the contrary. The European Free Trade Association (EFTA, 1960-85) allowed Portugal to develop an export base in manufacturing ("pajama republic"). But European integration did not balance mutual political responsiveness with economic interdependence. Public and private interest groups seeking transfers from the state and thereby holding on to the tax base took advantage of European structural funds. The whole process reinforced some of the interests vested in state intervention ("get out of my tax!").

To see how the voracity of social groups (Tornell and Lane 1997) may be exacerbated by the fiscal constitution, recall that it describes relations between the state and the population involving both taxes and transfers. It includes the institutions enforcing the social contract and thus incorporates various exchange rate regimes, monetary standards and state revenues. The existence of several redistributive revolutions during the XX century and the political instability observed during most of it did not change the fiscal constitution all that much. The voracity of public and private interest groups seeking transfers from the state and thereby holding on to the tax base remains from domain revenues to the European structural funds, underlining the limits of external pressure in this regard (my 2002). The pattern of political and economic integration was therefore one of excessive gradualism, due to resilience of public sector, hurting corporate governance and the fights against corruption.

Parallel legitimacies were serious before 1982 Constitutional Amendment which abolished Council of the Revolution (my 1984, also Linz 1981). Dynamics of bipolar executive (Head of State vs. Head of Government) have been source of instability, under both minority and majority governments (1987/95). General elections on February 20 instead of mid 2006 for the first time since 1987 led to first majority government of socialist party

*Credibility*

Given the record of structural adjustment, foreign investment and wage moderation among cohesion countries Portugal was supposed to gain most from single market according to EC simulations (.7% p.a. growth gain from 1995 to 2010). Honohan (1995) saw the economy as still more open on trade than capital account, even though instruments promoting foreign investment abroad were available since the restoration of convertibility in 1992. Government policy did make a difference in the strong FDI into Brazil on the part of state-owned enterprises after 1995. The fast rise in private indebtedness after entry into the euro was secured also opened a substantial external deficit.

Lankes and Venables (1996) suggest policy credibility more important than proximity to EU markets in attracting “right” FDI (corruption discourages FDI, favours bank loans). Relative unit labour costs deteriorate brutally; warning from central bank in early 2001 ignored, outcome worse than forecast. In 1998-02 ULC rose by 4.3% vs. 1.9% in EU, same rate 1.6% in 03-05. This contrasts with experience of real wage flexibility before euro entry (Krugman and Macedo 1981).

The so-called deficit bias in modern democracies implies a special role for the Minister of Finance. In Portugal, this role required both earning credibility abroad and selling stability at home, which has led to oscillations and a much shorter average tenure than the prime minister (my 1996 and 2004). For example from April 2002 until July 2005, there have been three prime ministers and four ministers of finance.

Tax revenues are a “common pool” whereas public expenditure benefits particular groups. This creates a bias towards budget deficits. The deficit bias can only be overcome by giving the Minister of Finance a strategic dominance over spending ministers in the budget process. The Prime Minister must back the Minister of Finance for the strategic dominance to be credible. Between 1985 and 1995, the Prime Minister was a former Finance Minister and he ensured the strategic dominance himself, alternating between Ministers who earned credibility abroad at the beginning of the mandate and Ministers who sold stability at home in the run up to new elections. This allowed two majority governments in 1987 and in 1991 but threatened reversals. The 1995 general election brought to power (in a minority government) a Prime Minister without economic background who chose an independent law professor to oversee the transition to the euro. Oscillations remained and the change of Minister after 1999 elections (together with Economy portfolio, i.e. becoming a spending Minister as well) did not solve reversal in EU policy. New appointment in mid 2001 prevented expenditure reduction program and Prime Minister resigned in the wake of defeat in December 2001 local elections.

Majority coalition government attacked budget crisis in 2002, with new Minister acknowledging violation of stability pact and introducing emergency restrictive measures during the downturn. Prime Minister resigned to go to Brussels in middle of adjustment in mid 2004. New government of same coalition gave conflicting signals about pursuing budgetary consolidation in 2005 and exacerbated "€ hold up" resulting from rising primary expenditure as % GDP, rising unit labour costs relative to other eurozone countries and pro-cyclical budgetary policy. Not clear whether adjustment since 2001 will be resilient (graph 2 contrasts IMF forecasts for 2000 and 2003 Article IV consultations, resp. pp 35 & 38). Pessimism in business circles because Iberian productivity comparisons are unfavorable, especially in manufacturing.

The instability of the last few years explains why tax reform and competitiveness moved into reverse after the introduction of the euro. The opportunity for structural change afforded by euro was lost and with it the improvements in fiscal discipline and competitiveness. Macro situation was unsustainable (current account, credit boom) and structural reforms went into reverse (tax reform, public sector wage negotiations). Deteriorating competitiveness may have helped win 1999 election, but at the cost of long term policy credibility and social disruptions. Budget crisis in 2001 was only attacked by new government in mid 2002 and a strongly pro-cyclical adjustment did not create opportunity for structural reform even then.

## Conclusion

No historical and geographical determinism but expectations of convergence after 1989 regime change were disappointed by expenditure voracity and pro-cyclical budgetary policy. In the absence of structural reforms (in good and bad times), industry has not been able to go beyond the “pajama republic” (smaller enterprises brought wage flexibility and full employment but lowered total factor productivity too much below Spain). Political instability (three Prime Ministers in three years) reflected underlying social malaise, and provided majority in February 2005 elections but still no reform momentum.Without a greater appeal to the *diaspora* and to young productive people everywhere, Portugal cannot leapfrog, and be “put on the map” like Ireland or Catalonia. Europe has been the main external pressure for better governance in Portugal. If Portugal continues to be a victim of the "€ hold up“, the tension between European and lusophone allegiances will continue and with it a renewed tension between political and financial freedom. This will stunt structural reforms and firms will not innovate and profit from globalization (BRICs boom), enlargement, Lisbon strategy and reinforced cooperation. If Portugal faces the Lisbon challenge successfully, this will induce improvements in the Lusophone business environment and governance will also improve at national and regional levels.

## Tables and Charts

### Table 1: West & Bric

| | GNI $tril | GNIcap $K | GNIcapPPP |
|---|---|---|---|
| **USA** | 9.8 | 24.3 | 24.3 |
| Euro | 6.3 | 20.7 | 23.8 |
| UK | 1.5 | 25.1 | 24.3 |
| China | 1.1 | .9 | 4.0 |
| Brazil | .5 | 3.1 | 7.1 |
| India | .5 | .5 | 2.8 |
| Russia | .3 | 1.3 | 6.9 |
| World | 31.4 | 5.1 | 7.4 |

Source: data from World Bank Atlas 2003

### Table 2: 5 structural indicators & targets

| Level (# from Estat) | EU25 | EU15 | US | Target 2005 | Target 2010 |
|---|---|---|---|---|---|
| Empl% (3) | 63 | 64 | 71 | 67 | 70 |
| Emp fem % | 55 | 56 | 66 | 57 | 60 |
| Emp old% (4) | 40 | 42 | 60 | | 50 |
| R&D % Y (6) | 1.9 | 2.0 | 2.8 | | 3.0 |

| | | | | | |
|---|---|---|---|---|---|
| Gr gas ems (12) | 91 | 97 | 113 | | 92 |

Source: data from Kok report and Eurostat

**Table 3: Indicators compared to US**

| Level (# from Estat) | ***EU25*** | EU15 | US | PT | SE |
|---|---|---|---|---|---|
| Empl% (3) | 91 | 100 | 140 | 68 | 106 |
| Emp fem % | 93 | 100 | 122 | 64 | 97 |
| Emp old% (4) | 96 | 100 | 113 | 74 | 117 |
| R&D % Y (6) | 101 | 102 | 91 | 126 | 90 |
| Gr gas ems (12) | 210 | 191 | 330 | 254 | 224 |

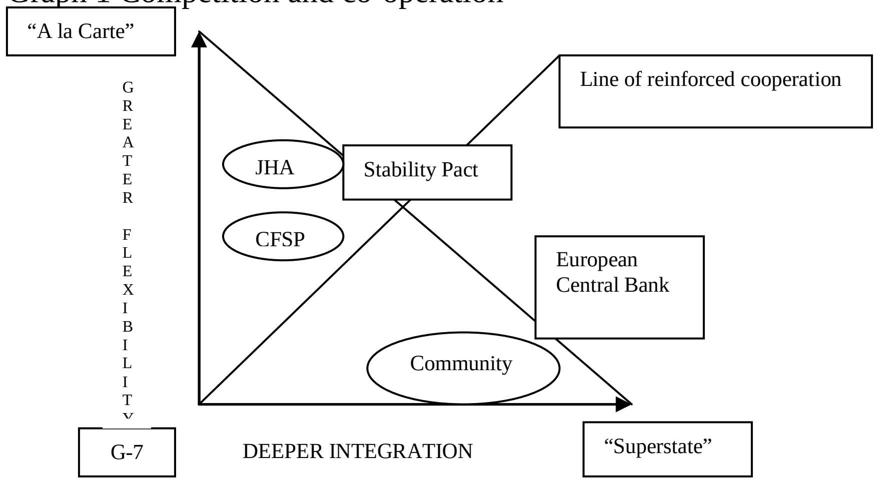
Source: data from Kok report and Eurostat

**Table 4: Structural indicators**

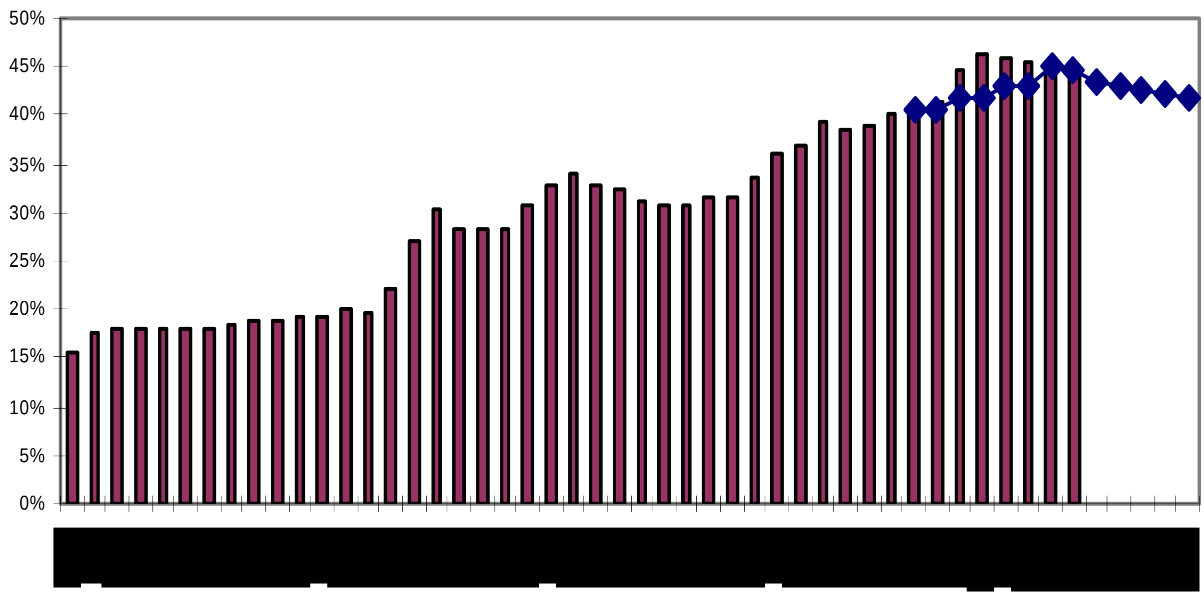
| Level | EU25 | EU15 | PT | SE |
|---|---|---|---|---|
| LTU% (10) | 4.0 | 3.3 | 2.2 | 1.0 |
| Disp Reg Empl (11) | 13 | 12 | 4 | 4 |
| Edu20-4% (5) | 77 | 74 | 48 | 86 |
| Bus.Inv %Y (8) | 17 | 17 | 19 | 13 |
| Poverty % (9) | 15 | 15 | 20 | 9 |

Source: data from Kok report and Eurostat

Graph 1 Competition and co-operation




Graph 2 Primary expenditures % GDP 1960-2009



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